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Family Tax Credits: Dependent Care and Earned Income (EIC) Credits

The dependent care and earned income credits help ease the burden of caring for dependents.

The dependent care credit is for working people who pay care costs which allow them the freedom to work. Depending on your income, the credit is 20% to 30% of up to \$2,400 of care expenses for one dependent and up to \$4,800 of expenses for two or more dependents. If your adjusted gross income exceeds \$28,000, the maximum credit is \$480 for one dependent and \$960 for two or more dependents.

The earned income credit (EIC) is provided to low-income workers who support children, and a limited credit is allowed to certain workers without qualifying children; see ¶25.8. For 1996, the EIC can be as much as \$2,152 if you have one qualifying child (¶25.8), \$3,556 if you have more than one qualifying child, and \$323 if you do not have a qualifying child.

If you have one or more qualifying children, the maximum EIC begins to phase out when either earned income or AGI is \$11,650 or more. If you do not have any qualifying children, the maximum EIC begins to phase out when either earned income or AGI is \$5,300 or more. You look up the credit amount in IRS tables included in the tax form instructions. The EIC is "refundable"; you will receive a refund from the IRS if the credit exceeds your tax liability.

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Proposed Family Tax Credit

A tax credit of \$500 for each dependent child under age 18 has been proposed. The credit would take effect in 1997 and would be phased out for higher-income families. Developments, if any, will be in the Supplement.

Dependent Care Credit

¶25.1 Qualifying for Child or Dependent Care Credit

Did you hire someone to care for your children or other dependents while you work? If so, you may qualify for a tax credit for the expenses. You may claim the credit even if you work part time. The credit is generally available to the extent you have earnings from employment. Your employer may have a plan qualifying for tax-free child care, and, if you are covered, you may be unable to claim a tax credit; *see* ¶25.5.

Where to claim the credit. The credit is claimed on Form 2441 if you file Form 1040, or on Form 1040A, Schedule 2. The size of the credit depends on the amount of care expenses and income. Depending on your income, the credit is 20% to 30% of up to \$2,400 of care expenses for one dependent and up to \$4,800 of expenses for two or more dependents. If your adjusted gross income exceeds \$28,000, the maximum credit is \$480 for one dependent and \$960 for two or more dependents. *See* the chart in ¶25.2.

Credit requirements. To qualify for the credit, you must:

1. Incur the care expenses in order to earn income. In the case of a married couple, this requires both spouses to work either at full- or part-time positions. An exception to the earned income rule is made for a spouse who is a full-time student or incapacitated (¶25.3). Qualifying care expenses are discussed at ¶25.5. Limits on the amount of qualifying costs are discussed at ¶25.2.
2. Maintain a household for a qualifying dependent; *see* ¶25.4. You must report the dependent's Social Security number on your return.
3. File jointly if you are married, unless you are separated under the rules of ¶25.6.
4. Hire someone *other than* your child who is under age 19 at the end of the year, your spouse, or a person you can claim as a dependent; *see* ¶25.5.
5. Have qualifying expenses in excess of tax-free reimbursements received from your employer; *see* ¶25.5.
6. Report on your tax return the name, address, and taxpayer identification number (Social Security number for individuals) of the child-care provider; *see* below.

Identifying care provider on your return. You must list the name, address, and taxpayer identification number of the person you paid to care for your dependent on Form 2441 if you file Form 1040, or on Form 1040A, Schedule 2. You do not need the taxpayer identification number if a tax-exempt charity provides the dependent care services. Failure to list the correct name, address, and number may result in a disallowance of the credit. To avoid this possibility, ask the provider to fill out Form W-10 or get the identifying information from a Social Security card, driver's license, or business letterhead or invoice. If a household employee has filled out Form W-4 for you, this may act as a backup record.

Withholding tax for housekeeper. Where you employ help to care for your dependent in your home, you may be liable for FICA (Social Security) and FUTA (unemployment) taxes; *see* ¶25.7.



Employer Reimbursements Reduce Credit

Expenses qualifying for the dependent care credit are reduced by any tax-free reimbursements under a qualified employer dependent care program. That is, the reimbursements reduce the \$2,400 expense limit for one dependent, or the \$4,800 expense limit for two or more qualifying dependents; *see* ¶25.5. Your employer will report reimbursements in Box 10 of your Form W-2. You figure the tax-free portion of the reimbursement, and any reduction to the credit expense base, on Form 2441 if you file Form 1040 or on Schedule 2 if you file Form 1040A.

¶25.2 Limits on the Care Credit

The credit is a percentage of expenses paid for the care of a dependent to allow you to work and earn income. Qualifying expenses are discussed at ¶25.5. The credit percentage depends on your income.

Limit on expenses. In figuring the credit, you may only take into account qualifying expenses (¶25.5) up to a limit of \$2,400 for one dependent, or \$4,800 for two or more dependents. The \$2,400 or \$4,800 limit applies even if your actual expenses are much greater. Further, the \$2,400 or \$4,800 limit must be reduced by tax-free benefits received from an employer's dependent care plan. Finally, if your earned income is less than the \$2,400 or \$4,800 limit, your credit is figured on the lower income amount.

Take into account only 1996 payments for 1996 services. Your credit for 1996 must be based on payments made in 1996 for care services provided in 1996. If you paid for 1995 services in 1996, you may be able to claim an additional credit on your 1996 return, but only in limited circumstances, as discussed at the end of this section. If in 1996 you prepay for 1997 services, you must allocate your payment. Only payments for 1996 services should be counted towards the \$2,400 or \$4,800 limit when figuring your 1996 credit.

Credit percentage. Depending on your income, a credit percentage of 20% to 30% applies to your expenses up to the \$2,400 (one dependent) or \$4,800 (two or more dependents) limit. The maximum credit is 30% for families with adjusted gross income of \$10,000 or less. For adjusted gross income over \$10,000, the 30% credit is reduced by 1% for each \$2,000 of adjusted gross income or fraction of \$2,000 over \$10,000, but not below 20%. The 20% credit applies to adjusted gross incomes exceeding \$28,000.

The dependent care credit is nonrefundable; it is limited to your tax liability. Furthermore, if you have tax preference items or adjustments subject to alternative minimum tax (¶23.1), the dependent care credit may be limited; follow the IRS instructions.

Allowable Credit

Your maximum credit

Adjusted gross income	Credit percentage	One dependent	Two or more dependents
\$10,000 or less	30%	\$720	\$1,440
10,001–12,000	29	696	1,392
12,001–14,000	28	672	1,344
14,001–16,000	27	648	1,296
16,001–18,000	26	624	1,248
18,001–20,000	25	600	1,200
20,001–22,000	24	576	1,152
22,001–24,000	23	552	1,104
24,001–26,000	22	528	1,056
26,001–28,000	21	504	1,008
28,001 and over	20	480	960

EXAMPLES

1. You pay \$6,000 to a neighbor to care for your two children while you work. Your adjusted gross income is \$31,000. The credit percentage of 20% is applied to the maximum expense limit of \$4,800, giving you a credit of \$960.
2. Same as above except you receive a tax-free reimbursement of \$2,500 from your employer's plan. The reimbursement reduces the \$4,800 expense limit to \$2,300 (\$4,800 – \$2,500); see ¶25.5. Your credit is \$460 (20% of \$2,300). If the tax-free reimbursement were \$4,800 or more (it cannot exceed \$5,000) no credit would be allowed.

Additional credit for 1996 payment of 1995 dependent care expenses. Payments made in 1996 for 1995 services may be eligible for an additional credit but only if you did not use up the \$2,400 or \$4,800 expense limit when claiming your 1995 credit.

For example, the cost of day-care services for your child in 1995 was \$3,000, half of which you paid in 1995 and half in early 1996. On your 1995 return, a credit was based on the \$1,500 of expenses paid in 1995. Since you used only \$1,500 of the \$2,400 expense limit in 1995, the \$900 of “unused” expenses is carried over to 1996. On your 1996 Form 2441 or Schedule 2 of Form 1040A, you multiply \$900 by a credit percentage based on your 1995 adjusted gross income. If your 1995 adjusted gross income was \$30,000, the credit percentage is 20%. Thus, your additional 1996 credit is \$180 (20% of \$900). The \$180 credit is claimed on Line 10 of Form 2441 or Schedule 2 (Form 1040A), and is in addition to the regular credit for 1996 care services. You must attach a statement explaining the carryover to 1996 and the computation of the additional credit.

¶25.3 Earned Income Test

To claim the credit, you must earn wage, salary, or self-employment income figured without regard to community property laws. Expenses for dependent care incurred while looking for a job may be included. However, you must have earnings during the year to claim the credit.

Earned income rule for married couples. Generally, both spouses must work at least part time, unless one is incapable of self-care or is a full-time student. If either you or your spouse earns less than the \$2,400 or \$4,800 credit base (¶25.2), the base is limited to the smaller income.

EXAMPLE

John and Mary are married. John earns \$4,000. Mary earns \$23,500. They incur care costs of \$5,000 for their two children, ages 5 and 7. Their adjusted gross income including interest earnings is \$27,742; their credit percentage is 21%. The regular \$4,800 credit base is limited to John's lower income of \$4,000. They may claim a credit of \$840 (\$4,000 × 21%).

Spouses who are students or disabled. An incapacitated spouse or a spouse who is a full-time student is considered to have earned income of \$200 a month if expenses are incurred for one dependent, or \$400 a month for two or more such dependents.

A full-time student is one who attends school full time during each of five calendar months during the year.

EXAMPLE

Same facts as in the Example above except John was a full-time student for nine months and earned no income for the year. The credit base is limited to \$3,600 (\$400 × 9).



No Credit If Neither Spouse Works

If both husband and wife are full-time students and neither works, they may not claim the credit for dependent care costs. While one spouse may be considered to have earned income of \$200 (or \$400) each month, the other spouse's earned income is zero. Care costs eligible for the credit are limited to the lesser amount of earned income, which in this case is zero.

¶25.4 Household and Dependent Tests

To claim the credit you must maintain as your principal home a household for at least one of the following dependents who lives with you:

1. A child *under the age of 13* whom you may claim as your dependent. If you are divorced or separated, and you had custody of the child for a longer time during the year than the other parent, you may be able to claim the credit even if the other parent is entitled to claim the child as a dependent; *see* ¶25.6.
2. Your spouse, if physically or mentally incapable of caring for himself or herself.
3. A dependent, regardless of age, who is physically or mentally incapable of caring for himself or herself. For example, he or she needs help to dress or to take care of personal hygiene or nutritional needs, or requires constant attention to avoid hurting himself or herself or others. Relatives who qualify, if disabled, are listed at ¶22.3. A nonrelative may also qualify if he or she is a member of your household for the entire year, except for temporary absences.

That a disabled dependent has gross income of \$2,550 or more, so that you may not claim an exemption, does not bar you from claiming a credit for his or her care costs.

EXAMPLE

You live with your mother, who is physically incapable of caring for herself. You hire a practical nurse to care for her in the home while you are at work. Payments to the nurse qualify as care costs. However, if you placed her in a nursing home, the cost of the nursing home would not qualify as dependent care costs; but *see* ¶17.11 for possible medical expense deduction.

If your child becomes age 13 during the year. Take into account expenses incurred for his or her care prior to the 13th birthday. However, you do not prorate the \$2,400 limitation. For example, if your child becomes age 13 on May 1 and you incurred \$2,400 in care expenses between January 1 and April 30, the entire \$2,400 qualifies for the credit.

You must pay more than half of household costs. You are considered to have maintained a household if you (or you and your spouse) provided more than half the maintenance costs in 1996. You also qualify if you paid more than half the costs during a lesser period in which you had care cost expenses. Rent, mortgage interest, property tax and insurance, utility bills, upkeep, repairs, and groceries are considered maintenance costs. Do not count costs of clothing, education, medical expenses, vacations, life insurance, mortgage principal, and capital improvements, such as replacing a boiler.

In determining costs of maintaining a household for a care period of less than a year, the annual household costs are prorated over the number of calendar months within the period care costs were incurred. A period of less than a calendar month is treated as a calendar month.

Household of two or more families. If two or more families share living quarters, each family is treated as a separate household.

EXAMPLES

1. The annual cost of maintaining a household is \$6,600, and the period during which child care costs qualified for the deduction is from June 20 to December 31. To meet the household test, you must furnish more than \$1,925 in maintaining the household from June 1 to December 31. The allocation covers seven months (June 1 to December 31).

$$\begin{aligned} \frac{7}{12} \text{ of } \$6,600 &= \$3,850 \\ 50\% \text{ of } \$3,850 &= \$1,925 \end{aligned}$$

2. Two women, each with children, share a house. If each pays more than one-half of the household costs for her own family, each is treated as maintaining her separate household for purposes of the credit.

¶25.5 Expenses Qualifying for the Credit

If you do not receive tax-free dependent care benefits from an employer's plan, you may take into account up to \$2,400 of the following types of expenses when figuring the credit for one dependent, or up to \$4,800 for two or more dependents. If you receive employer-financed dependent care, tax-free reimbursements reduce the \$2,400 or \$4,800 base.

1. Costs of caring for your child under age 13, incapacitated spouse, or incapacitated dependent in your home. If you pay FICA or FUTA taxes on your housekeeper's wages (¶25.7), you may include your share of the tax (employer) as part of the wages when entering your qualifying expenses. Also include your housekeeper's share of FICA tax if you pay it. Note that these taxes may more than offset your allowable credit.

The manner of care need not be the least expensive alternative. For example, where a grandparent resides with you and may provide adequate care for your child to enable you to work, the cost of hiring someone to care for the child is still eligible for the credit.

2. Ordinary domestic services in your home, such as laundry, cleaning, and cooking (but not payments to a gardener or chauffeur). Expenses for the dependent's food, clothing, or entertainment do not qualify. Food costs for a housekeeper who eats in your home may be added to qualifying expenses.
3. Outside-the-home care costs for a child under age 13, as in a day-care center, day camp, nursery school, or in the home of a babysitter. Outside-the-home care costs also qualify if incurred for a handicapped dependent, regardless of age, provided he or she regularly spends at least eight hours per day in your home. However, the cost of schooling in the first grade or higher does not qualify for the credit. Costs for sleep-away camp also do not qualify for the credit.

The cost of driving a dependent to or from a day-care center or similar transportation does not qualify for a child-care credit. However, the Tax Court allowed a child-care credit for supervised bus transportation; the transportation was part of the actual child care.

Payments to relatives. No credit may be claimed for payments made to relatives for whom a dependency exemption is allowable (¶22.3). Thus, if you pay your mother to care for your child and you cannot claim your mother as a dependent, such payments qualify for the credit. The same rule applies for payments to unrelated persons who live with you and qualify as your dependents; see ¶22.4.

No credit may be claimed for payments to your child who is under 19 years of age at the close of the tax year, whether or not you may claim the child as a dependent.



Day-Care Center or Nursery School

The amount you pay to a day-care center or nursery school for a dependent child under age 13 is eligible for the credit, even if it covers such incidental benefits as lunch. However, tuition for a child in first grade or higher is not taken into account. If the dependent is not your child, costs for care outside the home qualify only if the dependent regularly spends at least eight hours per day in your home. Up to \$2,400 a year of outside-the-home care expenses may be taken into account in figuring the credit for one dependent, and up to \$4,800 for two or more.

Allocating expenses when employed less than entire year. When an expense covers a period, part of which you were gainfully employed or in active search of gainful employment and part of which you were not employed or seeking employment, you must allocate expenses on a daily basis.

EXAMPLE

You are employed for only two months and 10 days. Monthly care expenses are \$300. Eligible care expenses amount to \$700 ($\300×2 months, plus $\frac{1}{3}$ of \$300).

Employer-financed dependent care reduces credit base. Tax-free reimbursements under an employer's dependent care program reduce the \$2,400 or \$4,800 credit base. For example, if you have one child and you receive a \$1,500 reimbursement of child-care costs from your company's plan, the amount eligible for the tax credit is reduced to \$900 ($\$2,400 - \$1,500$). A reimbursement of \$2,400 or more would bar any credit. The \$4,800 credit expense limit for two or more dependents is similarly reduced. On your Form W-2, your employer will report the amount of tax-free reimbursement; see ¶3.7.

If your employer's plan allows you to fund a reimbursement account with salary reduction contributions that are excluded from taxable pay (¶3.14), reimbursements from the account are consid-

ered employer-financed payments that reduce the \$2,400 or \$4,800 credit base. In deciding whether to make salary reduction contributions, you should determine whether the tax-free reduction will provide a larger tax savings than that provided by the credit. If your tax bracket is higher than 15%, taking the salary reduction is advantageous. Even if you expect to be in the 15% bracket, you should compare the estimated tax savings from the credit with the estimated savings from a salary reduction. You may find that the salary reduction provides the larger tax savings, taking into consideration not only the decrease in federal income tax, but also the Social Security tax and state and local taxes avoided by using the salary reduction. Further, by lowering your adjusted gross income, a salary reduction may enable you to claim a larger IRA deduction if you are subject to the deduction phase-out rule (¶8.3), or a larger deduction for miscellaneous itemized deductions subject to the 2% floor (¶19.1).

Allocation if expenses cover noncare services. If a portion of expenses is for other than dependent care or household services, only the portion allocable to dependent care or household services qualifies. No allocation is required if the nondependent care services are minimal.

EXAMPLES

1. A person accepts a full-time position and sends his 12-year-old child to boarding school. The expenses paid to the school must be allocated. The part representing care of the child qualifies; the part representing tuition does not.
2. A full-time housekeeper is hired to care for two children, ages 9 and 12. The housekeeper also drives the mother to and from work each day. The driving takes no longer than 30 minutes. No allocation is required because the nondependent care services of chauffeuring are minimal.



Care Costs Qualifying as Medical Expenses

Care costs, such as a nurse's wages, may also qualify as medical expenses, but you may not claim both the dependent care credit and the medical expenses deduction. If your care costs exceed the amount allowed as dependent care costs, the excess, to the extent it qualifies as a medical expense, may be added to other deductible medical costs.

EXAMPLE

You pay \$6,000 for care of your child in your home. The expenses also qualify as medical expenses. Assume your adjusted gross income is \$17,000. Your dependent care costs are limited to \$2,400 and you may claim a credit of \$624 ($\$2,400 \times 26\%$). The balance of \$3,600 is deductible as medical expenses. If you had no other medical costs, your medical deduction would be \$2,325 after deducting the 7.5% limitation on medical costs ($\$3,600 - \$1,275$, or 7.5% of \$17,000).

¶25.6 Rules for Separated Couples

A married person generally must file a joint return to claim the credit (¶25.1), but if you are living apart from your spouse you may claim the credit on a separate return if you meet the following tests:

1. You maintain as your home a household which is the principal place of abode of a qualifying person (¶25.4) for more than half the year;
2. You furnish over half the cost of maintaining the household for the entire year; and
3. Your spouse was not a member of the household during the *last six months* of the year.

If you satisfy these tests, you are treated as unmarried and may claim the credit on a separate return. You do not have to take your spouse's income into account or show that he or she is employed in order to claim a credit.

Your child may be a qualifying person for purposes of the credit even if you cannot claim the child as your dependent. This favorable rule applies if: you are legally divorced or separated, separated under a written agreement, or you lived apart from your spouse during the last six months of 1996; you or you and the other parent had custody of the child for more than half the year and provided more than half of the child's support; and you are the *custodial parent* (have custody longer than the other parent. If these tests are met, you may claim the credit for care of a dependent child who is under age 13 or physically or mentally incapable of caring for himself or herself even though you waive the dependency exemption on Form 8332 or are unable to claim the exemption under a pre-1985 divorce or separation agreement. The noncustodial parent may not claim the credit even if he or she is allowed the exemption.

Employment Taxes for Household Employees

¶25.7 Paying and Withholding Taxes for Household Employees

If you employ someone to care for your children or disabled dependents in your home, clean your residence, cook, or provide other personal services in or around your home, you may be obligated to pay and withhold Social Security and Medicare taxes (FICA) and also pay federal unemployment taxes (FUTA). FICA or FUTA taxes do not apply if the household worker is the employee of an agency

that assigns the position, sets the fee, and requires reports from the worker.

The reporting requirements for FICA are at ¶25.8, and the FUTA requirements at ¶25.9.

Income taxes. Income tax withholding is not required for a household employee, but if the employee requests it and you agree, you pay the withheld tax under one of the reporting options discussed in ¶25.8. Withholdings are based on a Form W-4 (Withholding Allowance Certificate) filed by the employee.

An employee who qualifies for the earned income credit may receive advance payments by giving you Form W-5; see ¶25.13.

¶25.8 Social Security and Medicare Taxes (FICA) for Household Employees

You generally must pay and withhold Social Security and Medicare taxes (FICA) if you pay cash wages of \$1,000 or more to a household employee in 1996. Wages paid to your spouse, child, or parent for household services are generally exempt from this tax, as discussed at the end of this section. Also exempt are wages of any amount paid to a household employee who is under the age of 18 at any time during the year, so long as he or she does not work full time as a household worker. For example, if you hire a student under age 18 as a baby-sitter, Social Security and Medicare taxes do not apply regardless of the amount of wages you pay. However, if wages of \$1,000 or more are paid to a person under 18 years of age who works full time as a household employee, Social Security and Medicare taxes apply.

Once payments to non-exempt employees equal or exceed \$1,000, the entire amount, including the first \$1,000, is subject to FICA taxes.

Tax rates. As an employer, you pay FICA at the rate of 7.65% of wages: 6.2% for Social Security and 1.45% for Medicare. For example, you pay a housekeeper \$125 a week (\$6,500 for the year). You must pay \$497.25 in FICA and either withhold the same amount from the housekeeper's wages or pay the housekeeper's share yourself. In the unlikely case that wages exceed the wage limit for Social Security taxes (for example, \$62,700 in 1996), there is an extra Medicare tax of 2.9%: 1.45% tax owed by you as the employer and 1.45% owed by the housekeeper. There is no wage limit on the additional 2.9% Medicare tax. You and the employee are each liable for the combined FICA rate of 7.65% (6.20% Social Security plus 1.45% Medicare) where 1996 wages are \$62,700 or less. If wages exceed \$62,700, the 7.65% rate applies to the first \$62,700, and the 1.45% rate applies to the excess.

If you do not withhold the employee's share of FICA taxes, you are liable for the full amount. If you pay the employee's share of FICA taxes instead of deducting it from wages, you must treat your payment as additional wages when you report the employee's wages on Form W-2, but the payment is not considered wages for Social Security and Medicare tax purposes.

When to report and pay FICA tax. You compute FICA tax on wages paid to household employees on Schedule H, which you attach to your Form 1040 or Form 1040A. The tax itself, both your share and the employee's share, is payable with your Form 1040 or Form 1040A. You must pay the tax by April 15, 1997, even if you obtain a filing extension.

In planning your 1997 liability, you can include an estimate of employment taxes in your regular income tax estimate, but your failure to consider employment taxes will not trigger an estimated tax penalty.

Reporting rules for self-employed persons who have regular business employees. Self-employed persons who have employees other than household employees may follow one of these two options:

1. Report FICA and FUTA taxes and any income tax withholding for household employees annually on Schedule H, and report FICA taxes and any income tax withholding for other employees quarterly on Form 941 and FUTA taxes annually on Form 940 (or 940-EZ); or
2. Report FICA taxes and any income tax withholding for *all* employees (household employees and other employees) quarterly on Form 941 and report FUTA taxes annually for all employees on Form 940 or Form 940-EZ.

Employers of household employees must also give copies of Form W-2 (Wage and Tax Statement) to each employee by January 31 of the year following the year of the employment. The employers must file Copy A of Form W-2 with the Social Security Administration by the last day of February of the following year.

Note: Late changes, if any, to the reporting rules for employers with both household employees and regular business employees will be in the Supplement.

Reporting rules for an estate. If a person who hired household help dies during the year and the estate continues to employ the employee for domestic work, the estate includes both the wages paid by the decedent and the estate to determine whether taxes are due under the \$1,000 test. Thus, if in 1996 a person before dying paid \$500 to a domestic and her estate continued to employ the domestic and paid wages of \$800, the estate is required to pay FICA taxes on wages of \$1,300.

Payments to your parent, child, or spouse. FICA tax does not apply to wages paid to your spouse for domestic services in your home. A similar exception applies to wages paid to your son or daughter under age 21, but note the rule that bars you from basing a dependent care credit on payments made to a child under age 19 (¶25.5). Further, FICA generally does not apply to wages paid to your father or mother for domestic work in your home unless (1) you are divorced or widowed, or your spouse is disabled; and (2) you have a child living at home who is under age 18 or is disabled.

¶25.9 Federal Unemployment Taxes (FUTA)

As an employer, you are also liable for FUTA (federal unemployment taxes) if you pay cash wages of \$1,000 or more for household services during any calendar quarter, or if you did so in any quarter in the preceding year. You do not pay FUTA on wages paid to your spouse, your parents, or your children under age 21. Your employee is not liable for FUTA.

The FUTA rate for 1996 is 6.2% on the first \$7,000 of cash wages. However, there is a credit for payments to a state unemployment fund which reduces FUTA liability.

For wages paid to a household employee in 1996, you will generally report FUTA on Schedule H, which you attach to your Form 1040. If you have regular business employees, *see* ¶25.8 for reporting options.

Earned Income Credit (EIC)

¶25.10 Qualifying Tests

For 1996, the earned income credit (EIC) may be claimed not only by workers with qualifying children who meet the tests below, but also, in limited cases, by childless workers.

CLAIMING THE EIC WITH QUALIFYING CHILDREN

You may claim the EIC on a 1996 return if you:

- Have earned income, such as wages and self-employment earnings, and also modified adjusted gross income of under \$25,078 if you have one qualifying child or under \$28,495 if you have two or more qualifying children. *See* ¶25.11 for the credit phase-out rules.
- Have a qualifying child who lived with you in your main home in the U.S. for more than six months in 1996; *see* below.
- File a joint return if married.
- File Schedule EIC with your Form 1040 or Form 1040A. On Schedule EIC, you identify and provide information about a qualifying child.

- Are not a qualifying child of another person.
- Include on your return your Social Security number and, if married, that of your spouse

A qualifying child. A qualifying child is your son, daughter, adopted child, grandchild, stepchild, or foster child who at the end of 1996 was under age 19, or under age 24 and a full-time student, or any age if permanently and totally disabled. To be a full-time student, a child must be enrolled during any five months for classes treated as full time by the school.

Household requirement. The qualifying child must have lived with you in your main home in the U.S. for more than six months. A foster child must have lived with you for all of 1996. Temporary absences for school or vacation count as time lived in your home.

A person in the U.S. armed forces who is stationed outside the U.S. on extended active duty is treated as maintaining a main residence within the U.S.

If you are married, you must file a joint return with your spouse to claim the credit. However, if your spouse did not live in your household for the last six months of the year, and you maintained a home for a child who lived with you for more than half of the year, you may claim the credit as a head of household; *see* ¶1.10.

Permanently and totally disabled. A person is permanently and totally disabled if: (1) he or she cannot engage in any substantial gainful activity because of a physical or mental condition; and (2) a physician determines that the condition has lasted or is expected to last for at least a year or lead to death.

Married child or qualifying child of another person. You may not take the earned income credit if your child is also a qualifying child of another person who has a higher adjusted gross income in 1996 than you do.

If your child was married at the end of 1996, he or she may be a qualifying child only if the child was claimed as a dependent on Form 1040 or Form 1040A, Line 6, or you waive the exemption in favor of the child's other parent, or the other parent may claim the exemption under a pre-1985 agreement.

If you are a qualifying child of another person, you may not claim the EIC even if you have a qualifying child and would otherwise qualify for the credit.

Nonresident aliens. An individual who is a nonresident alien for any part of the year is not eligible for the credit unless he or she is married and an election is made by the couple to have all of their worldwide income subject to U.S. tax.

CLAIMING THE CREDIT WITHOUT QUALIFYING CHILDREN

If you do not have a qualifying child, you may claim the EIC on a 1996 return if you:

- Have earned income, such as wages and self-employment earnings, of under \$9,500, and also modified adjusted gross income under \$9,500. *See* ¶25.11 for the credit phase-out rule.
- Have your main home in the U.S. for more than six months in 1996.
- Are at least 25 but under age 65 at the end of 1996. If filing a joint return, either you or your spouse must satisfy this age test.
- File a joint return if married.

- Are not a dependent of another taxpayer.
- Are not a qualifying child of another taxpayer.
- Include your Social Security number on your return, and, if married, that of your spouse.

The rules discussed earlier for armed forces personnel and non-resident aliens with qualifying children also apply to individuals without children.

¶25.11 Income Tests

For purposes of the credit, earned income includes wages, salary, tips, commissions, jury duty pay, union strike benefits, certain disability pensions, tax-free meals and lodging from your employer, the rental value of a parsonage, U.S. military basic quarters and subsistence allowances, combat pay, voluntary salary deferrals, and self-employment earnings.

Disqualifying income. For 1996, an individual is not eligible for the earned income credit if he or she has "disqualified income" exceeding \$2,200. Disqualified income includes interest (taxable and tax-exempt), dividends, net rent and royalty income, net capital gain income, and net passive income that is not self-employment income.

For individuals who, as of June 26, 1996, had elected on Form W-5 to receive advanced earned income payments from their employers (¶25.13), the disqualifying income rules do not take effect until 1997.

Credit phases out with income. If you have one qualifying child (¶25.10), the 1996 credit begins to phase out in the IRS table (¶25.12) if either earned income or modified adjusted gross income (MAGI) is \$11,650 or more, and no credit is allowed if either earned income or MAGI is \$25,078 or more.

If you have two or more qualifying children, the phaseout of the 1996 credit also begins when either earned income or MAGI is at least \$11,650 and the credit is completely phased out if either earned income or MAGI is \$28,495 or more.

If you do not have any qualifying children, the phaseout of the credit begins when either earned income or MAGI is at least \$5,300, and the credit is completely phased out if either amount is \$9,500 or more.

Modified adjusted gross income. Modified adjusted gross income (MAGI) is generally equal to your adjusted gross income but certain losses are disregarded for EIC purposes. These include: net capital losses; net losses from trusts and estates; net losses relating to nonbusiness rents and royalties; and 50 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

There is an exception to the MAGI rule for individuals who, as of June 26, 1996, had elected on Form W-5 to receive advanced earned income payments from their employers (¶25.13). For them, the credit phase-out rule for 1996 will be based on adjusted gross income, as under pre-1996 law, and the MAGI phase-out rule will apply starting in 1997.

Self-employed. If you were self-employed in 1996, your earned income for credit purposes is the net earnings shown on Schedule SE, *less* the income tax deduction for 50% of self-employment tax claimed on Line 25 of Form 1040. If your net earnings were less than \$400, the net amount is your earned income for purposes of the credit. If you had a net loss, the loss is subtracted from any wages or other employee earned income. If you are a statutory employee, the income reported on Schedule C qualifies for the credit.

Foreign earned income. If you work abroad and claim the foreign income exclusion, you may *not* take the credit.

¶25.12 Look Up EIC in Government Tables

After completing a worksheet in the IRS instructions which determines whether your earned income credit is based on your earned income or modified adjusted gross income (¶25.11), you then look up the amount of your credit in an IRS table.

If you have children, the table provides a phaseout of the credit once 1996 earnings are at least \$11,650. If you have only one qualifying child (¶25.8), your credit is completely phased out if either earned income or modified adjusted gross income is \$25,078 or more. If you have more than one qualifying child, the 1996 credit is completely phased out if either earned income or modified adjusted gross income is \$28,495 or more. *See* ¶25.11 for modified adjusted gross income rules.

If you do not have a qualifying child, the phaseout of the credit starts when earned income or modified adjusted gross income is \$5,300 or more and no credit is allowed if either amount is \$9,500 or more.

EXAMPLE

Jane is divorced. Her only income in 1996 is wages of \$10,500. She supports her eight-year-old daughter, who lives with her for the entire year.

To find her credit, Jane turns to the IRS Table in the instruction book accompanying her return. In the table, the credit shown for her income bracket is \$2,152.

¶25.13 Advance Payment of Earned Income Credit

If you believe you are entitled to an earned income credit, you may file a certificate, Form W-5, with your employer to have a portion of the credit added to your paycheck throughout the year. To get advanced earned income payments you must have a qualifying child (¶25.10).

If you receive any advance payments, you must report them on Form 1040 or Form 1040A; your employer will include the amount in Box 9 of your Form W-2. If you receive advance payments in excess of the credit you are entitled to, the excess is treated as a tax you owe when you file your return. If the credit you are entitled to exceeds the advance payments, the excess credit reduces any other tax you owe. If the credit exceeds your liability, the difference is refunded to you.

¶25.14 Adoption Credit in 1997

Starting in 1997, a tax credit of up to \$5,000 may be available for the qualifying costs of adopting a child under age 18, or a person who is physically and mentally incapable of self-care. If a state determination has been made that a child is a "special needs" child, the maximum credit is \$6,000. The credit is phased out ratably for those with adjusted gross income (after certain adjustments) between \$75,000 and \$115,000.

If credit-eligible expenses are incurred over more than one year, the maximum credit of \$5,000 or \$6,000 applies to the overall costs; the credit limit is per child, not per year.

The credit may be claimed for qualifying adoption expenses only in the year after the year the expense is incurred unless the adoption became final in the year the expense is incurred.

Employer plans. An exclusion from income will also be available to employees if adoption expenses are paid through a qualifying employer program, subject to rules similar to that of the credit.

Further details concerning the adoption credit and exclusion will be in the Supplement.